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JUL 3 1 1980

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

COMPLETED
ORIGINAL

Guidance Needed On Use Of Natural Gas Price Escalator Clauses

Congressional intent has been unclear concerning the use of price escalator clauses in existing natural gas contracts to obtain Natural Gas Policy Act of 1978 prices. In December 1978, the Federal Energy Regulatory Commission issued interim regulations disallowing the use of such clauses. Subsequently, the Commission issued several orders, one of which reversed the original decision concerning these clauses. After the reversal, affected parties petitioned the courts to review the legality of these actions.

The Commission should establish a system to monitor the results of its price escalator clause decisions. In future situations involving energy issues of national importance, it should seek clarification of congressional intent when appropriate and analyze economic impacts before making decisions.

The Congress should consider amending the Natural Gas Policy Act of 1978 to provide guidance on the price escalator clause issue.

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JULY 25, 1980

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-197556

To the President of the Senate and the
Speaker of the House of Representatives

This report addresses the Federal Energy Regulatory Commission's decision to allow natural gas producers the opportunity to use the price escalator clauses in existing natural gas contracts to obtain the maximum lawful prices mandated by the Natural Gas Policy Act of 1978.

We are sending copies of this report to the Chairman, Federal Energy Regulatory Commission.

Comptroller General
of the United States

A

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

GUIDANCE NEEDED ON USE OF NATURAL GAS PRICE ESCALATOR CLAUSES

D I G E S T

Price escalator clauses permit producers to raise the initial price of natural gas over a period of time (fixed clause) or to raise the price when some outside event occurs (indefinite clause).

In December 1978, the Federal Energy Regulatory Commission issued interim regulations implementing the Natural Gas Policy Act of 1978. The Commission stated that establishing maximum lawful prices under the act would not trigger any indefinite price escalator clauses in existing interstate or intrastate contracts. The Commission reversed itself in March 1979, and stated that it would not prevent price escalator clauses from operating to obtain the maximum lawful prices under the act.

The Commission's initial decision, as well as its reversal, created much controversy over the treatment of price escalator clauses. In addition, congressional intent concerning treatment of these clauses was not clearly defined, and the Commission did not adequately assess the economic impact on natural gas consumers.

HOW PRODUCERS USE PRICE ESCALATOR CLAUSES

In most cases, producers use price escalator clauses as contractual authority to collect the ceiling prices under the act. However, collectively, pipeline purchasers and consumer advocates (third parties) have filed about 10,000 protests against the use of price escalator clauses. Such use has led to price increases ranging from a few cents to over $2 per million British thermal units above prices charged prior to the passage of the act. (See pp. 5 to 7.)

In dealing with this issue, the courts have been petitioned to assess the legality of Commission actions related to price escalator clauses.

VIEWS VARY ON CONGRESSIONAL INTENT CONCERNING PRICE ESCALATOR CLAUSES

Views differ on the Commmission's implementation of the Natural Gas Policy Act of 1978 and on congressional intent. Producers feel that they have been appropriately allowed to escalate prices in existing contracts to the new ceiling prices. But consumer organizations believe that prices for existing natural gas supplies have been unjustly increased, resulting in windfall profits for producers and unnecessary price increase to consumers. (See pp. 8, and 10 to 13.)

When the Congress passed the Natural Gas Policy Act of 1978, it did not specify how price escalator clauses in existing contracts would be treated.

The Commission concluded that congressional intent is unclear with respect to area rate clauses in existing interstate contracts and that the Conference Report reveals little in the way of direct and specific guidance. The Commission recognized that the Congress identified area rate clauses as indefinite price escalators. Yet, it decided that the Congress probably did not intend to prevent the use of all indefinite price escalator clauses, but rather intended to prevent the use of those which had been previously prohibited. With respect to existing intrastate contracts, the Commission believed that the Congress clearly intended that producers be allowed to collect prices mandated by the act. (See pp. 8 to 10.)

GAO's examination of the act and its legislative history disclosed that neither clearly addressed whether price escalator clauses in existing interstate contracts can be used to obtain the prices under the law. The Conference Report stated that producers could charge the maximum lawful prices if the language in

their contracts so permits. However, no explanation was given as to what type of language in the contracts would constitute contractual authority. Similarly, the act contained no reference to price escalator clauses in existing intrastate contracts other than to discuss how they would be handled after 1984. However, the Conference Report indicated that these clauses may raise existing intrastate contract prices. (See pp. 12 to 13.)

COMMISSION ACTIONS ON PRICE ESCALATOR CLAUSE ISSUE

After the Commission issued its December 1978 interim regulations prohibiting the operation of price escalator clauses in existing interstate and intrastate contracts, it subsequently issued orders addressing the price escalator clause issue. (See p. 14.)

Order 23 reversed the Commission's prohibition against producers using price escalator clauses to collect the maximum lawful prices under the act. The Order stated that interstate pipeline purchasers and interested third parties could file protests. Then in June 1979, the Commission issued Order 23-A, stating that parties to existing natural gas contracts could amend them to provide adequate contractual authority to collect the ceiling prices under the act. Again in June, the Commission issued Order 23-B outlining the necessary protest procedures. However, in an August 1979 order, the Commission stated that the burden of going forward with evidence that contractual authority does not exist lies with third party protesters. (See pp. 14 to 16.)

The Commission roughly estimated that the impact of using price escalator clauses to collect prices under the law would be about $2.6 billion in 1979. However, Commission officials admitted that the accuracy of this estimate was very questionable and was not developed to assist in the issuance of Order 23. (See pp. 16 to 18.)

GAO attempted to develop a consumer impact analysis from the data on file at the

Commission but found that it was impossible to make any meaningful analyses from the data on file at the Commission. (See pp. 17 to 18.)

As a result of the controversy over the Commission's treatment of price escalator clauses, several parties have filed petitions in various circuit courts of appeals to review the Orders. (See pp. 18 to 19.)

RECOMMENDATIONS TO THE CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION

The Chairman, Federal Energy Regulatory Commission, should:

--Establish a system to monitor the results of its price escalator clause decisions. This system should include appropriate data collection and disclosure requirements enabling the Commission to (1) calculate the impact of using price escalator clauses to obtain Natural Gas Policy Act of 1978 prices and (2) determine what regulatory revisions it should make. The system should be operating prior to the 1980-81 heating season.

--When appropriate, obtain clarification of congressional intent in future situations involving energy issues of national importance. The Commission also should conduct accurate economic impact analyses prior to making decisions and establish monitoring systems to determine if intended results are achieved.

MATTER FOR CONSIDERATION BY THE CONGRESS

The lack of any congressional guidance on the issue would result in the Federal courts ultimately resolving a major energy issue. Thus, GAO believes that the Congress should consider amending the Natural Gas Policy Act of 1978 to provide guidance with respect to the price escalator clause issue.

AGENCY COMMENTS

The Commission disagreed with GAO's conclusion that it should have performed a more complete and accurate economic impact analysis of the price escalator clause issue. Also, the Commission disagreed with GAO's recommendation to establish a system to monitor the results of its price escalator clause decisions. (See app. I.)

GAO believes that a more accurate economic analysis and a system to monitor the Commission's price escalator clause decisions would be appropriate in this case and consistent with the President's Executive Order 12044 entitled, "Improving Government Regulations." Such analyses would help the Commission in deciding the need for, or the adequacy of, its price escalator clause regulations.

GAO's detailed evaluation of these comments is contained in chapter 5, beginning on page 22.

Tear Sheet

APPENDIX Page

I Letter dated May 7, 1980, from Chairman, Federal Energy Regulatory Commission 24

ABBREVIATIONS

Btu	British thermal unit
EIA	Energy Information Administration
FERC	Federal Energy Regulatory Commission
FPC	Federal Power Commission
GAO	General Accounting Office
NGA	Natural Gas Act of 1938
NGPA	Natural Gas Policy Act of 1978

CHAPTER 1

INTRODUCTION

Interstate natural gas has been regulated since the passage of the Natural Gas Act of 1938 (NGA), (15 U.S.C. 717). The act made the Federal Power Commission (FPC) 1/ and its successor, the Federal Energy Regulatory Commission (FERC) responsible for protecting the interest of natural gas consumers. That responsibility still applies today to interstate gas produced under existing contracts. 2/

With the passage of the NGA, the Congress intended to insure that the ultimate consumers of natural gas received the lowest reasonable rate; protection from exploitation by natural gas companies; and complete, permanent, and effective protection against excessive rates and charges. The act authorized FPC to regulate natural gas companies engaged in the transportation and sale of natural gas in interstate commerce for resale.

For 16 years after the passage of the NGA, FPC did not regulate natural gas wellhead prices because it believed it lacked such authority. However, in 1954, the U.S. Supreme Court ruled that the regulation of pipeline purchasers selling gas in the interstate market was not sufficient to prevent higher prices from being passed on to consumers (Phillips Petroleum v. Wisconsin, 347 U.S. 672 (1954)).

Subsequent to that ruling, FPC and its successor, FERC, used three different methods of regulating prices at the wellhead--cost of service, area rate, and nationwide. But all three of these methods failed for one reason or another.

Under the cost of service method, natural gas wellhead prices included actual production costs which were equal to or greater than market rates.

1/ FPC's regulatory functions for natural gas were transferred to the Federal Energy Regulatory Commission on October 1, 1977, pursuant to the Department of Energy Organizational Act (42 U.S.C. 7107).

2/ For purposes of this report, existing contracts refer to those interstate and intrastate which were entered into prior to enactment of the Natural Gas Policy Act of 1978, effective November 9, 1978.

Prices under the area rate method were based on the average cost of production for a particular producing area of the country, while nationwide prices were based on FPC's projections of the national average cost of production. The area rate and nationwide methods generally resulted in higher prices for gas sold in the intrastate market than for sales of interstate gas.

The Natural Gas Policy Act of 1978 (NGPA), which was signed into law on November 9, 1978, mandated a new legislative framework for the regulation of natural gas. Although the NGA continues to be of significance with respect to interstate gas produced under existing contracts, in many respects, it has been limited, replaced, or superseded by the NGPA. Cost-based methodology, used in setting natural gas prices in the interstate market, has been replaced with a series of maximum statutory ceiling prices for first sales of natural gas. The NGPA, however, stated that the maximum lawful prices under the NGPA are ceiling prices and do not supersede or nullify the effectiveness of any contractual agreement to pay a lower price. Also, the NGPA expanded Federal jurisdiction to encompass not only sales made in interstate commerce but in intrastate commerce as well. In addition, the NGPA specifies deregulation dates for certain types of natural gas, requires incremental pricing for gas sold to certain end-users, establishes gas curtailment priorities for the protection of high-priority users, provides the President the authority to declare a natural gas emergency if a gas shortage exists or is imminent, and authorizes certain emergency sales and allocation.

Under title I of the NGPA, there are eight different price categories of first sales of natural gas. Four categories explicitly require that either a jurisdictional Federal or State agency determine whether the producer can collect the maximum lawful price. These categories are (1) new natural gas and certain natural gas produced from the Outer Continental Shelf, (2) new onshore production wells, (3) high-cost natural gas, and (4) stripper well natural gas.

The other four categories of first sales of natural gas do not require a prior determination because they are tied to previously existing contractually set prices or established by FPC or FERC price levels. They are (1) natural gas dedicated to interstate commerce, (2) natural gas sales under existing intrastate contracts, (3) natural

gas sales under rollover contracts, 1/ and (4) other categories of natural gas sales.

OBJECTIVES OF REVIEW

Controversy has arisen concerning the use of price escalator clauses in existing natural gas contracts to obtain NGPA prices. Price escalator clauses are common to natural gas contracts and generally state that the contract price can increase periodically. FERC initially promulgated regulations prohibiting the use of such clauses in existing natural gas contracts and on March 13, 1979, decided to allow producers the opportunity to use them to obtain NGPA ceiling prices for flowing gas. The purpose of this report is to provide information to the Congress by describing FERC's decision to allow the use of price escalator clauses in existing contracts to obtain the maxmimum lawful price mandated by the NGPA. Because FERC's actions on the price escalator clause issue are currently in litigation, this report does not take a position on these actions.

SCOPE OF REVIEW

In conducting our review of the price escalator clause issue, we interviewed officials from FERC, State regulatory commissions, trade associations, producers, and pipeline purchasers; examined applicable regulations, policies, procedures, and practices pertaining to natural gas contracts; and reviewed the NGPA and its legislative history, FERC's contract files, producers' reports and blanket affidavits, pipeline purchase gas adjustment filings, computerized data, and consumer impact data.

We attempted to calculate the economic impact of using price escalator clauses to obtain NGPA prices. However, due to data gaps and inconsistencies, we were unable to develop any impact estimates on natural gas consumers.

1/ A rollover contract is any contract entered into, on, or after November 9, 1978 (the date of enactment of the NGPA) for the first sale of natural gas that was previously subject to an existing contract which expired at the end of a fixed term.

CHAPTER 2

VARIOUS TYPES OF PRICE ESCALATOR CLAUSES ARE USED TO COLLECT NGPA PRICES

Producers and pipeline companies generally entered into long-term contracts, some of which may have been for 20 years or more. These contracts usually covered the initial prices and volume of gas to be taken; the delivery, gathering, processing, and metering conditions; and the method and timing of payments. Because the parties to the contracts could not predict the course of future events, most provided a mechanism in their contracts whereby the initial price for natural gas may increase in response to the passage of time or to some outside event. This mechanism is known as a price escalator clause.

TYPES OF PRICE ESCALATOR CLAUSES

Price escalator clauses in natural gas contracts may be fixed price escalator clauses or indefinite price escalator clauses. Fixed price escalator clauses usually provided for automatic increases in the price for delivered gas. These automatic increases were in accordance with a fixed schedule of specific price increases.

Indefinite price escalator clauses began appearing in contracts in the late 1940s and early 1950s. There are a variety of indefinite price escalator clauses, but the most commonly used are the

--favored nations clause, which requires the price paid to increase to keep pace with other prices paid for natural gas in some defined area;

--FPC clause or area rate clause, which would operate to increase the contract price whenever FPC or FERC set a new, "just and reasonable rate";

--price reference clause, which provides that the increase in contract price be tied to any increase in the delivered price of some other fuel; and

--redetermination clause, which provides that as of a particular time during the contract term or upon the occurrence of a stated event, the parties will negotiate a new price.

Prior to the enactment of the NGPA, many of these price escalator clauses were inoperative in interstate

contracts under FERC regulations. Only those fixed and indefinite price escalator clauses that were outlined in section 154.93 of FERC's regulations implementing the NGA were permitted. These were provisions that

--change a price in order to reimburse the seller for all or any part of the changes in production, severance, or gathering taxes levied upon the sellers;

--change a price to a specific amount at a definite date;

--permit a change in price to the applicable just and reasonable area ceiling rates which had been or which may be prescribed by FERC for the quality of gas involved; and

--allow for price redetermination once in 5-year contract periods during which there is no provision for a change in price.

After the NGPA was enacted, FERC issued interim regulations which prohibited the triggering of indefinite price escalator clauses by the establishment of NGPA prices. However, after evaluating the results of open meetings, oral arguments, and public hearings on the matter, FERC decided its initial view was incorrect and issued an order stating that it would not preclude the use of some indefinite price escalator clauses to obtain NGPA prices. FERC's interim regulations and order reversing these regulations are discussed in detail on pages 14 and 15.

HOW PRICE ESCALATOR CLAUSES ARE USED TO COLLECT NGPA PRICES

In many cases, producers are using indefinite price escalator clauses as contractual authority to collect NGPA ceiling prices. However, pipeline purchasers and third parties can protest to FERC natural gas price increases if they believe the clauses in the existing contracts do not provide the necessary contractual authority to collect the higher NGPA prices. To protest the use of price escalator clauses in existing intrastate contracts, pipeline purchasers and third parties must deal with the appropriate State courts. Although FERC officials have estimated that about 10,000 interstate contracts have been protested, producers can collect higher NGPA prices, subject to refund if FERC upholds the protests. These price increases could range from a few

cents to over $2 per million British thermal units (Btu's) over what pre-NGPA prices were, depending upon the NGPA price category for which the natural gas produced under the particular contract qualifies.

The following examples demonstrate how producers use price escalator clauses as contractual authority to collect NGPA prices for natural gas flowing prior to enactment of the NGPA. In order to obtain NGPA prices for new natural gas, gas from new onshore production wells, high cost natural gas, and stripper well natural gas, a producer must apply to the appropriate jurisdictional agency (Federal or State) for a well determination. Once the State regulatory agency or the United States Geological Survey (in the case of Outer Continental Shelf gas or gas located on Federal lands) determines that the natural gas qualifies under one of the above categories, the producer may charge up to the maximum lawful price for the category for which its gas qualifies so long as the parties of the contract agree that appropriate contractual authority exists to collect that price and no parties protest that there is a lack of contractual authority to collect these prices.

For example, producers can obtain the NGPA price for new gas, new onshore production wells, high-cost natural gas, and stripper well natural gas, if the jurisdictional agency has determined that the producers' production qualifies for one of these categories and there is no protest filed with respect to contractual authority. Prices for these categories of gas were $2.204, $2.428, and $2.598 per million Btu's, respectively, as of April 1980. Also, the producers can use their price escalator clauses to receive the appropriate monthly escalations to these prices in the same manner that real growth and inflation adjustments can be obtained for gas qualifying as new natural gas.

For interstate gas flowing prior to the NGPA's enactment, producers are using their price escalator clauses as contractual authority to collect the monthly inflation adjustment as called for in the NGPA.

Using an actual case to illustrate, one pipeline purchaser has been receiving about 10 billion cubic feet of gas per year from a group of small producers. The 1979 average price this pipeline purchaser paid to these producers was $1.34 per million Btu's. The prices paid ranged from $0.65 to $1.70 per million Btu's, depending upon when the gas was placed into production. Under the NGPA, 90 percent of this gas can qualify for the stripper well price, which would average about $2.55 per million Btu's for 1979. This case was recently appealed in three circuit courts

of appeals. If the producers prevail, this pipeline purchaser could be paying anywhere from $0.85 to $1.90 per million Btu's more under the NGPA for this flowing gas than it would have paid under prices existing prior to enactment.

CHAPTER 3

VIEWS VARY ON CONGRESSIONAL INTENT CONCERNING PRICE ESCALATOR CLAUSES

In many cases, prices for natural gas produced and flowing prior to the passage of the NGPA have escalated to the new maximum ceiling prices because of FERC's approval of the use of area rate clauses in existing interstate contracts and other indefinite price escalator clauses in existing intrastate contracts. Whether the Congress intended for the NGPA to trigger these price escalator clauses has been one of the most discussed topics since the act's passage. The economic consequences of the decision are massive, and much controversy has arisen.

Views on FERC's implementation of the act and congressional intent vary greatly, depending upon one's point of interest. Producers feel that they have been appropriately allowed to escalate prices in existing contracts to the new maximum ceiling prices. On the other hand, consumer organizations believe that prices for existing natural gas supplies have been unjustly increased, resulting in windfall profits for producers and unnecessary price increases for consumers.

The disagreement surrounds those contracts in existence at the time the NGPA was passed. While there is no question that new contracts for natural gas produced after the NGPA's passage may receive the maximum prices for which they qualify, there is considerable disagreement as to whether prices in contracts written before the act's passage should be allowed to increase to the new maximum ceiling. While the producers view FERC's decision to allow the triggering of price escalator clauses to be appropriate and in keeping with the intent of contracts between them and their pipeline purchasers, consumers feel that the act's intent has been violated and that producers have administratively received from FERC that which they were legislatively denied by the Congress.

CONGRESSIONAL STATEMENTS CONCERNING PRICE ESCALATOR CLAUSES

Even though the Congress did not specify in the NGPA how price escalator clauses in existing contracts would be treated, it made several statements concerning the operation of indefinite price escalator clauses in the

act's Conference Report. For example, the Conference Report contains the following:

> "The conference agreement establishes a maximum lawful price for first sales of natural gas under an existing intrastate contract or any successor to an existing intrastate contract. The maximum lawful price depends upon the contract price in effect on the date of enactment of this Act. If the contract price in effect on the date of enactment is less than the new gas ceiling price, the maximum lawful price for any subsequent month is the lower of (1) the price under the terms of the existing contract in effect on the date of enactment, or (2) the new gas price. Thus, the price under the contract may escalate through the operation of both fixed price escalator clauses and indefinite price escalator clauses in existence as of the date of enactment, but the price may not exceed the new gas price.
>
> "If the contract price in effect on the date of enactment is greater than the new gas price, the maximum lawful price for any subsequent month is the higher of (1) the contract price in effect on the date of enactment escalated by the monthly equivalent of the annual inflation adjustment factor, or (2) the new gas price. Thus the operation of both fixed escalator clauses and indefinite price escalator clauses is limited to the rate of the inflation adjustment until the price equals the new gas price ***."

The Conference Report further states that

> "This section of the conference agreement is not intended to apply to interstate contracts in existence as of the date of enactment. Such contracts are currently subject to regulation by the Commission pursuant to the Natural Gas Act. Commission regulations bar the use of indefinite price escalator clauses in interstate sales.
>
> "Some intrastate contracts currently in existence contain indefinite price escalator clauses which can be triggered by a number of factors, including adjustments by the Commission of just and reasonable rates established under the Natural Gas Act. The Conferees do not intend that the mere establishment of the ceiling prices under this Act shall trigger indefinite price escalator clauses in existing intrastate contracts. Once natural gas is sold pursuant to the ceiling prices under this Act, such clauses would be activated as limited by this section."

Additional comments concerning the operation of indefinite price escalator clauses in interstate contracts were made by Senator Henry M. Jackson, Senate Floor Manager for Consideration of the Natural Gas Policy Act. He stated "* * * operation of these clauses is prohibited by current Commission Regulations. There is no intent to change or otherwise modify that prohibition." 1/

FERC'S VIEWS

FERC concluded that the intent of the Congress is unclear with respect to area rate clauses in existing interstate contracts and that the discussion in the Conference Report and the statement made by Senator Jackson during the time of Senate floor consideration reveal little in the way of direct and specific guidance. According to FERC, comments in the Conference Report confuse instead of clarify the issue, and actually lie at the root of the debate.

While FERC recognized that the Congress identified area rate clauses as indefinite price escalators, FERC decided that it is unlikely that the Congress intended to prevent the use of all indefinite price escalators but only intended to prevent the use of those which had been previously prohibited. FERC's position centers on the past use of area rate clauses which were allowed under pre-NGPA regulations. Accordingly, FERC has concluded that certain indefinite price escalators, such as favored nations, redetermination, and spiral escalation clauses, have always been prohibited in interstate contracts and therefore it is likely that the Congress intended their continued prohibition. On the other hand, FERC stated that area rate clauses have not been prohibited and that it is unlikely that the Congress intended to prohibit what has previously been permitted. Nevertheless, questions still remain as to whether the area rate clauses should be used to raise existing prices to the new NGPA ceiling. The answer to this question, FERC declared, must be linked to the intent of the parties to the contract--the producers and pipeline purchasers.

Since most interstate contracts written prior to the passage of the NGPA contain some type of price escalator clause, FERC's determination meant that the producers and pipeline purchasers would ultimately decide whether area rate clauses provided adequate contractual authority to trigger existing prices to the new maximum ceilings.

1/ 95 Cong. Rec. S.15021 (daily ed. Sept. 13, 1978).

With respect to existing intrastate contracts, FERC believed congressional intent was clear. It stated that, generally speaking, fixed price and indefinite price escalator clauses in existing intrastate contracts could permit escalation to NGPA levels in accordance with the terms of the contract. FERC said that under the NGPA, price escalator clauses in existing intrastate contracts could permit an increase in price up to, but not in excess of, the NGPA new gas price. In addition, FERC specified that contract interpretation would be left up to the parties of the contract, and the State courts should rule on any disagreements.

CONSUMERS' VIEWS

FERC's decision to allow the triggering of area rate clauses in existing interstate contracts has been widely criticized by State public utility commissions, consumer groups, natural gas distributors, and others. It is argued that the comments in the Conference Report make it clear that indefinite price escalator clauses in interstate contracts should not be triggered. Further, it is argued that the prices prescribed by the NGPA are incentive prices to encourage exploration of new gas supplies and therefore are not applicable to currently flowing gas. In addition, dissenters argue that NGPA prices are clearly maximum ceiling prices and that contracts providing for somewhat lesser prices are clearly in keeping with the intent of the act. Also, it has been asserted that the triggering of area rate clauses runs counter to congressional intent in Title II of the NGPA concerning incremental pricing, which protects consumers from large immediate price increases by requiring industrial boiler fuel users to bear the burden of high cost gas. Another argument surrounds the NGPA's providing of a transition period for price decontrol between enactment and 1985. It is argued that the triggering of area rate clauses nullifies the effectiveness of the prescribed transition period.

Some consumers addressed congressional intent with respect to price escalator clauses in existing intrastate contracts. Consumer advocates argued that most price escalator clauses in existing intrastate contracts do not authorize producers to raise their prices up to a congressionally mandated price. Therefore, consumers said escalation to NGPA ceilings is contrary to the intent of the act, which stated that NGPA price levels will not supersede or nullify the effectiveness of prices established under existing contracts.

Other consumer organizations did not address congressional intent concerning price escalator clauses in existing contracts but expressed concern over the potential for increased prices. In fact, the State legislatures of Oklahoma and Kansas enacted legislation limiting the price to which gas produced under existing intrastate contracts could rise. The NGPA permits States to establish any price for natural gas so long as it does not exceed NGPA's maximum ceilings.

PRODUCER/PIPELINE PURCHASER VIEWS

Producers have taken the position that the Congress did not specifically prohibit the triggering of area rate clauses in interstate contracts but only limited their operation in certain circumstances. Therefore, the omission of such prohibitions, led producers to believe that the Congress must have intended their operation. Further, most of the interstate producers have indicated that the inclusion of area rate clauses in their interstate contracts was intended to permit escalation to the highest prices permitted by law. Likewise, most of the interstate pipeline purchasers have indicated that they intended that producers receive maximum prices and that prices be increased through the use of area rate clauses whenever existing maximum ceilings were increased. Since the producers and most pipeline purchasers agree that the Congress intended for them to receive maximum prices, they feel that prices in existing interstate contracts have been appropriately allowed to escalate to the new maximum ceiling prices.

Producers and most pipeline purchasers also believe that the Congress intended for other price escalator clauses in existing intrastate contracts to operate to collect NGPA prices. They cited the Conference Report, which expressly states that both fixed price and indefinite price escalator clauses can operate in existing intrastate contracts to allow escalation up to the new gas price established under the NGPA.

GAO EXAMINATION OF THE NGPA AND LEGISLATIVE HISTORY

Our examination of the NGPA and its legislative history disclosed that neither clearly states whether price escalator clauses in existing interstate contracts can be used to obtain NGPA prices.

For example, the NGPA made no direct reference to price escalator clauses in existing interstate contracts, and the Conference Report provided no more meaningful guide to

congressional intent than did the NGPA. The Report stated that producers could charge NGPA maximum lawful prices if the language in their existing contract so permits. However, the Report made no further explanation as to what type of language in the contracts would constitute appropriate contractual authority. It also stated that FERC regulations bar the use of indefinite price escalator clauses in interstate sales.

In existing intrastate contracts, the NGPA contained no reference to price escalator clauses other than to discuss how they would be handled after 1984. But the Conference Report indicated that these clauses may raise existing intrastate contract prices to the price mandated by the NGPA for new gas only if the contract so permits.

CHAPTER 4

FERC ACTIONS ON

PRICE ESCALATOR CLAUSE ISSUE

FERC'S REVERSAL OF INTERIM REGULATIONS ALLOWS PRODUCERS TO COLLECT NGPA RATES

On December 1, 1978, FERC issued interim regulations which prohibited the use of price escalator clauses in existing interstate and intrastate contracts to obtain NGPA prices. But on March 13, 1979, FERC issued Order 23, which reversed these regulations by stating that it would not preclude producers from collecting NGPA prices for gas produced under existing contracts. In addition, FERC issued subsequent orders (1) allowing existing contracts to be amended to provide contractual authority to collect NGPA prices and (2) establishing procedures whereby aggrieved parties could protest the charging and collection of NGPA prices. However, FERC made these decisions without performing an adequate economic impact analysis. Furthermore, FERC's reversal and subsequent decisions added to the controversy surrounding the price escalator clause issue and left producers, pipeline purchasers, and consumer groups confused as to what the ultimate policy on the issue would be.

This reversal resulted from FERC's re-evaluation of the issue, which was prompted by numerous comments on, and requests for, clarification of the interim regulations. After evaluating the results of open meetings, oral arguments, and public hearings on the matter, FERC decided its initial view was incorrect and issued Order 23.

FERC's argument of including the price escalator clause prohibition in its interim regulations was that it only had 3 weeks to issue them and did not have time to perform a detailed analysis of the price escalator clause issue. Thus, it decided that the section of the Conference Report referring to intrastate contracts 1/ could be equally applicable to existing interstate contracts. In reversing the interim regulations, FERC stated

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1/ Page 83 of the Conference Report states that the "* * * conferees do not intend that the mere establishment of the ceiling prices under this Act shall trigger indefinite price escalator clauses in existing intrastate contracts."

that its principal flaw in adopting them was that it focused too narrowly on the literal text of its prior regulations which prohibited the use of certain indefinite price escalator clauses. FERC said that allowing or disallowing price escalator clauses in existing contracts to operate to obtain NGPA prices should be linked to questions of contractual interpretation and the intent of the parties to that contract. Therefore, FERC had no objections to the parties to existing contracts using certain price escalator clauses to obtain NGPA prices.

Order 23 allows producers and pipeline purchasers the freedom to interpret their existing contracts to collect NGPA rates. As a result, price escalator clauses, which were contained in contracts drawn up before the NPGA's enactment, are being interpreted to allow escalation up to NGPA incentive-based prices as well as cost-based levels. Therefore, area rate clauses in existing interstate contracts, which FERC previously had ruled could be used only to obtain cost-based, "just and reasonable rates," as established under the NGA, are being interpreted as adequate contractual authority to collect all NGPA prices. Likewise, other price escalator clauses, some of which FERC had previously prohibited, are being interpreted as contractual authority to collect both cost-based and incentive-based NGPA prices.

FERC ORDER ALLOWS AMENDMENTS TO EXISTING CONTRACTS

To further clarify Order 23, FERC issued Order 23-A on June 12, 1979. This order stated that parties to existing contracts could amend their contracts to provide adequate contractual authority to collect NGPA prices. To illustrate, assume a contract contained a fixed price escalator clause which called for a fixed price increase after a certain period of time. If the parties to the contract agreed, they could have amended the contract by adding a price escalator clause allowing the collection of NGPA prices instead of a fixed price increase.

FERC PROTEST PROCEDURES PLACE BURDEN OF GOING FORWARD WITH EVIDENCE ON THIRD PARTY PROTESTERS

FERC Order 23 stated that interstate pipeline purchasers could protest to FERC their producers'/suppliers' use of price escalator clauses in existing contracts to obtain NGPA prices. Also, the order specified that interested third parties such as State commissions, local distribution companies, or consumers could also file protests with FERC contesting

the use of price escalator clauses as contractual authority to collect NGPA prices.

FERC published protest procedures in Order 23-B, issued on June 21, 1979, and further clarified its position on protests in Order on Rehearing of Order 23-B, issued on August 6, 1979. Under the protest procedures, the burden of going forward with evidence of lack of contractual authority is placed on the third party protester. FERC presumes that the parties to the contracts know what their intent was when they drew up the escalator clauses in their contracts and are truthful in asserting that intent. A third party protester can rebut this presumption by presenting enough evidence that contractual authority did not exist.

If such evidence is presented, the presiding Administrative Law Judge will hold hearings, with the burden of proof shifting to the parties to the contract. If the third party evidence is insufficient to demonstrate lack of contractual authority, the Administrative Law Judge will summarily dismiss the protest.

In contrast to this procedure, the NGA, which still applies to interstate contracts entered into prior to enactment of the NGPA, allowed third parties to challenge producer filings for higher rates through public hearings. During the rate increase hearing, the burden of proving that such increases were just and reasonable fell on the pipeline purchaser.

Many third parties believe that many existing contracts do not contain the proper legal wording to allow escalation up to NGPA levels but are not sure whether they can provide enough evidence to avoid a summary dismissal by the Administrative Law Judges. Even if the Administrative Law Judges decide that certain protests contain enough evidence to conduct hearings, there is nothing to preclude the parties of the contracts from amending them to provide specific contractual authority to collect NGPA rates.

CONSUMER IMPACT

FERC did not develop an accurate economic estimate prior to issuing Order 23. While it was clear that producers would benefit from the collection of NGPA prices, there was no certainty concerning the effect of FERC's decisions on consumers. FERC roughly estimated that the use of price escalator clauses in existing contracts to obtain NGPA prices would be $2.6 billion for 1979. However, FERC officials admitted that the accuracy of this estimate

was very questionable, and it was not developed to assist in the issuance of Order 23.

We attempted to perform impact analyses first by using FERC data which had been entered into the Energy Information Administration's (EIA's) 1/ data system and then by manually extracting data from FERC forms filed by producers and pipeline purchasers. In both cases, we encountered many problems, such as data gaps and inconsistencies, which hindered us in making any meaningful analyses. Specifically, we discovered that

--a 4-year gap existed in the data submitted to EIA, which made it impossible to determine whether contracts entered into between 1972 and 1976 contained price escalator clauses;

--FERC had not verified the information transferred to EIA;

--erroneous data, such as inoperative contracts, were in the system;

--duplicative information was filed;

--there were inconsistencies in what was supposed to be similar data reported on separate forms;

--the data was collected and organized in such a way that several FERC offices would have to be contacted to obtain pre-NGPA prices, NGPA prices, volume affected, and escalator clause information, to name a few; and

--due to poor control over the removal of documents, FERC had no idea where certain natural gas contracts were located.

Although we could not perform our own economic impact analysis, we received impact estimates from four States and three pipeline purchasers. The State of Oklahoma estimated that the culmulative impact of allowing price escalator clauses to operate in intrastate contracts would be $2.1 billion from 1979 through 1984. However, the State

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1/ Section 205 of the Department of Energy Organization Act (42 U.S.C. 7101) mandated that the Energy Information Administration be established within the Department of Energy to centralize the energy data and information system.

legislature passed a law limiting the use of these clauses to $600 million for the 6-year period, thus saving its intrastate consumers about $1.5 billion. Also, the Kansas State legislature passed similar legislation, saving its intrastate users about $125 million over a 5-year period. The States of New York and California stated that natural gas prices to their consumers would increase yearly by about $600 million and $160 million, respectively, if price escalator clauses in existing contracts operate to collect NGPA prices.

In addition, three pipeline purchasers provided us with a total yearly economic impact estimate of $127.5 million. This estimate depends on whether small producers which supply a portion of their gas are allowed to use price escalator clauses to obtain NGPA prices.

Since it is apparent that the economic impact of allowing escalator clauses in existing contracts to operate fully could be in the billions of dollars by 1984, we believe that FERC should have conducted an impact analysis prior to making its decisions. By not developing an impact estimate, FERC made decisions resulting in increased producer revenues without determining their effect on consumers and without assurance that these price increases would result in additional production. A more accurate impact estimate could have been beneficial to FERC in making its decisions on the price escalator issue.

PENDING ACTIONS WILL DETERMINE OUTCOME OF PRICE ESCALATOR CLAUSE ISSUE

There are several actions pending before FERC or the courts which, when decided, could set the precedent for how price escalator clauses in existing contracts will be handled. These actions include court petitions for review of Orders 23, 23-A, and 23-B, and thousands of protests filed with FERC.

Several parties filed petitions for review of Order 23 with different circuit courts of appeals. However, two parties, simultaneously and mutually exclusively of each other, filed petitions for review in different courts earlier than the other petitioners. Since both parties filed their petitions at the same time, there is controversy over which court will hear the case. According to FERC officials, the party representing consumer interests believes that the court it petitioned will rule more favorably toward consumers, while the producer petitioner believes hearing the case in the court it petitioned will benefit producers.

On January 3, 1980, FERC issued an Administrative Law Judge's Findings of Fact, which stated that the producer petitioner was the first party to appeal Order 23 and the Order on Rehearing of Order 23. This finding was forwarded to the FERC commissioners, who issued an order affirming the Administrative Law Judge's finding and forwarded it to the courts. The courts will ultimately decide which circuit court will hear the case.

In addition, parties have petitioned the courts to review Orders 23-A and 23-B. According to FERC officials, the courts probably will review these orders in the same proceeding with Order 23 because the issues are interrelated and because it would be difficult to examine them independently of each other. Also, FERC officials said virtually every aspect of the price escalator clause issue will be heard in the courts and the final decision will greatly affect the treatment of these clauses.

Pipeline purchasers and third parties have filed several protests with FERC in accordance with Order 23-B. As of late 1979, 15 different pipeline purchasers had protested about 200 contracts. In addition, FERC officials stated that FERC's staff, acting as a third-party protester, had protested about 3,000 contracts whose price escalator clauses contain language referring to "FPC or successor authority." Other third parties have protested close to 10,000 contracts. However, the only protest where proceedings have begun involves several small producers that are attempting to obtain NGPA prices for flowing gas. In this case, the presiding Administrative Law Judge issued a decision on August 10, 1979, which was contrary to Order 23. The FERC commissioners reviewed this decision and on March 4, 1980, issued Opinion 77, which reversed the presiding judge's decision and remanded the proceeding to him for further consideration. The opinion stated that the purpose of the remand was to allow the parties to make offers of proof as to the intent of their existing contracts and to conduct additional proceedings, including a hearing, as the presiding judge considers necessary. In addition, on May 2, 1980, several parties appealed Opinion 77 in three different circuit courts of appeals.

CHAPTER 5

CONCLUSIONS AND RECOMMENDATIONS

The price escalator clause issue is one of the most controversial to arise from the passage of the NGPA. If ultimately it is decided that NGPA prices will trigger price escalator clauses in existing contracts, the result could be an immediate and dramatic increase in the cost of some natural gas. At stake are billions of dollars of additional charges to natural gas consumers.

Much of the controversy centers around the different views expressed by producers, pipeline purchasers, and consumers on congressional intent relating to the treatment of price escalator clauses in existing natural gas contracts. The NGPA makes no direct reference to the treatment of price escalator clauses in existing contracts other than to discuss how price escalator clauses in existing intrastate contracts will be handled after 1984. The Conference Report provides no meaningful guidance with respect to the use of price escalator clauses in existing interstate contracts but specifies that these clauses may raise existing intrastate contract prices to the NGPA new gas price if the contract so permits.

To deal with this issue, FERC first issued interim regulations disallowing the use of price escalator clauses in existing contracts to obtain NGPA prices. Subsequently, FERC issued (1) Order 23, which reversed its interim regulations by stating that it would not preclude producers from collecting NGPA prices for natural gas produced under existing contracts; (2) Order 23-A, which permitted the parties to existing contracts to amend them to provide contractual authority to collect NGPA prices; and (3) Order 23-B, which placed the burden of going forward with evidence that existing contracts do not contain contractual authority to collect NGPA prices on third party protesters. Order 23-B is in contrast to the burden of proof procedures in the NGA, which state that at any rate hearing, producers must demonstrate that their prices are just and reasonable.

FERC did not make a detailed study of the economic impact of using price escalator clauses to obtain NGPA prices prior to issuing these orders. As discussed in chapter 4, FERC estimated the impact of the price escalator clause issue to be a $2.6-billion price increase to consumers for 1979. However, by FERC's own admission, this estimate was very rough and did not give an accurate picture of

what the impact would be. FERC should have made a more complete and accurate estimate of the impact in determining whether to allow the use of price escalator clauses.

FERC's orders are currently being litigated in the Federal courts. Many parties, representing both industry and consumer interests, petitioned the courts to review these orders. Thus, the lack of any congressional guidance on the issue will result in the Federal courts ultimately resolving a major energy question. But, the courts may not be the best means by which to decide an issue that the Congress did not address in passing the NGPA and that has a nationwide impact on natural gas prices. To help resolve the price escalator clause issue, we believe that the Congress should consider amending the NGPA to provide guidance with respect to the issue.

This issue and the controversy surrounding it are instructive for future situations involving energy issues having a significant national impact such as the price and/or allocation of energy resources. In such situations, it is important that the Congress provide policy guidance to the regulatory agency responsible for implementing the legislation. Energy issues having a nationwide impact should not be left to the courts for final decision.

If the Congress fails to provide policy guidance in such situations, we believe that the agency should return to the Congress for specific direction, when appropriate. Resolution may require a congressional amendment to the statute. In our view, the regulatory agency, in such situations, does not abdicate its responsibility to interpret and implement the legislative programs that the Congress establishes. Rather, it will have acted prudently to avoid subsituting judicial decisions for issues which should be resolved by legislative determinations.

RECOMMENDATIONS TO THE CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION

We recommend that the Chairman, Federal Energy Regulatory Commission:

--Establish a system to monitor the results of its price escalator clause decisions. This system should include appropriate data collection and disclosure requirements enabling the Commission to (1) calculate the impact of using price escalator clauses to obtain NGPA prices and (2) determine what regulatory revisions it should make. The system should be operating prior to the 1980-81 heating season.

--When appropriate, obtain clarification of congressional intent in future situations involving energy issues of national importance. FERC also should conduct accurate economic impact analyses prior to making decisions and establish monitoring systems to determine if intended results are achieved.

MATTERS FOR CONSIDERATION BY THE CONGRESS

The lack of any congressional guidance on the issue would result in the Federal courts ultimately resolving a major energy issue. Thus, we believe that the Congress should consider amending the NGPA to provide guidance with respect to the price escalator clause issue.

AGENCY COMMENTS AND OUR EVALUATION

FERC, by letter dated May 7, 1980, provided comments on a draft of this report. (See app. I.) FERC disagreed with our conclusion that it should have made a more complete and accurate economic impact analysis of the price escalator clause issue. Also, FERC disagreed with our recommendation to establish a system to monitor the results of its price escalator clause decisions. In addition, FERC provided us with detailed technical comments.

Economic impact analysis

FERC stated that its role regarding the price escalator clause issue was to give effect to congressional intent and not second-guess the incentive pricing system designed by the Congress. It added that contractual authorization depends upon legal construction rather than upon the economic impact of a congressional action. FERC said the real issue before it was the legal question of when and under what circumstances the seller has adequate contractual authority to collect the maximum NGPA price.

We recognize that FERC's main role regarding the escalator clause issue was to interpret congressional intent in order to implement the NGPA. However, a more accurate impact analysis could have benefitted FERC's decisionmaking on the price escalator clause issue. Such an analysis would have been consistent with the President's March 23, 1978, Executive Order 12044 entitled, "Improving Government Regulations." The Order states that agency heads will ensure that regulatory analyses are performed early in the decisionmaking process for all regulations which will result in an annual impact of $100 million or more on the economy.

Although, FERC, as an independent agency, is not subject to the requirements of Executive Order 12044, the Chairman, FERC, has stated that the agency will make every effort to comply with the Order.

Monitoring system

FERC stated that although a system to monitor the results of the price escalator clause decisions would provide useful statistics, such a system would result in new data collection requirements. FERC added that new data collection requirements would contradict its efforts to comply with Executive Order 12044.

While we do not advocate the collection of excessive data, we believe that monitoring the effect of regulations, including conducting economic impact analyses, is an essential part of good regulatory practice. We do not agree that the gathering of data for the purposes of monitoring the results of regulatory decisions would contradict Executive Order 12044. On the contrary, it would be consistent with the Order, which states that agencies will periodically review their regulations to ensure that they are achieving the policy goals of the Order. Monitoring the effect of the price escalator clause decisions would enable FERC to make appropriate regulatory revisions and to determine the continued need for/or adequacy of its price escalator clause regulations.

FEDERAL ENERGY REGULATORY COMMISSION

WASHINGTON 20426

MAY 7 1980

Mr. J. Dexter Peach
Energy and Minerals Division
General Accounting Office
Washington, D.C. 20548

Dear Mr. Peach:

We appreciate the opportunity to review and comment on the General Accounting Office (GAO) draft report entitled "Treatment of Price Escalator Clauses Resulted in Much Controversy". The Federal Energy Regulatory Commission (FERC) agrees that the treatment of price escalator clauses has been a controversial and complex issue which has been made all the more difficult by the ambiguous legislative history of the Natural Gas Policy Act of 1978 (NGPA).

In the NGPA, the Congress set maximum lawful prices for various categories of natural gas. The Commission did not view itself as having either the discretion or the authority to mitigate the impact of Congressionally set prices. Rather, the Commission's role is to properly implement the rate structure as established by Congress. Therefore, on the issue of price escalator clauses, the Commission's principle responsibility was to review existing contractual relationships and to determine whether they contain proper legal authority for the producer (seller) to collect maximum lawful prices under the NGPA.

In the draft report, GAO appears to criticize the FERC for failing to adequately assess the economic impact of the indefinite price escalator clause issue prior to taking final action. Our fundamental response to this criticism is that the GAO misinterprets the Commission's role in implementing the NGPA. That role is to give effect to Congressional intent; it is not the Commission's responsibility or authority to second-guess the incentive pricing system designed by the Congress or to limit the impact of those prices. Ours is a fundamentally legal role in this instance. Contractual authorization turns upon legal construction rather than upon a finding of who gains and who loses under alternative contract interpretations.

As the Commission's implementation of the NGPA has focused on contract law and established Congressional intent, rather than reviewing the economic impact of Congressional action, the financial consequences of the indefinite price escalator clause should not have had an overriding influence on the question of proper prices. The real issue before the Commission was the legal question of when and under what circumstances the seller has adequate contractual authority to collect the maximum lawful price.

The draft report recommends that the Commission establish a system to monitor the results of our price escalator clause decisions. While such a system could gather useful statistics, the negative impacts of such a system must be reviewed. One of the goals of the NGPA was to streamline procedures, avoid unnecessary industry reporting and reduce government regulation. A monitoring system such as the one advocated in the draft report would mean instituting new data collection requirements. It should be noted that our efforts to comply with the President's Executive Order on Regulatory Reform have been well received by both the Administration and the general public; new data collection requirements would contradict these efforts.

In conclusion, even if the Commission had had access to better information on potential economic impacts under alternative interpretations of indefinite price escalator clauses, the responsibility of the Commission would have remained the same. The Commission's task was to make a legal interpretation regarding the use of indefinite price escalators based on contract law and the NGPA, rather than to limit the effect of Congressional policy as articulated in the NGPA.

Editorial and factual comments will be found in the enclosure. We appreciate the opportunity to comment on this draft report and trust you will consider our comments in preparing the final report.

Sincerely,

Charles B. Curtis
Chairman

Enclosure

GAO note: The enclosure is not included in this report.

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